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Letter Ruling 93-7: Investment Activities of a Security Corporation: Short-term Security Placements and the Purchase of Security Futures

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May 24, 1993

You have requested a ruling on behalf of your client, ***** (the "Corporation"), as to the validity of two types of transactions under the security corporation provision, G.L. c. 63, § 38B.

I. FACTS

A. Securities Placement

The first transaction proposed by the Corporation is one in which securities owned by the Corporation would be provided to an unrelated third party (the "Dealer") on a short term basis for a fee. In conjunction with this conveyance the Dealer would transfer to the Corporation as surety an equal amount of comparable securities. At all times during the transaction (the "Placement Transaction"), the Corporation would retain ownership of the transferred securities (the "Transfer Securities") and bear all of the risks and rewards of such ownership.

The Dealer is typically a securities dealer with positions and/or operational objectives that sometimes require securities it does not own. For example, the Dealer might acquire the Transfer Securities because it has sold a certain amount of an identical security on a given day (the "Dealer Sale"), but finds that, because of strong demand for that security, it cannot purchase the requisite amount for delivery until the following day. The Dealer would enter into the Placement Transaction until it could acquire the securities necessary to complete the Dealer Sale. Upon the acquisition of the securities sold in the Dealer Sale, the Dealer would return the Transfer Securities to the Corporation.

The Transfer Securities would be debt securities of the U.S. Treasury and discount notes and debentures issued by U.S. Governmental agencies. The Placement Transaction would enhance the Corporation's total return on its portfolio by adding to the yield of the Transfer Securities.

We assume, as you state, that a large number of institutional investors engage in transactions similar to the Placement Transaction. In addition, we assume that the proposed Dealers will not be affiliates of the Corporation. We note as a practical matter that the Placement Transaction may be appropriately characterized as a short term loan of securities.

B. Entering, Holding Futures Contracts

The second transaction proposed by the Corporation is the entering into and holding of certain financial futures. A financial future is a contract to deliver or take delivery of a standardized amount of a specified instrument on a future date at a specified price. In some cases, where delivery of the instrument would be difficult, the contract may be settled by cash payment. The financial futures which the Corporation proposes to hold are:

1. U.S. Treasury Bill Futures. Futures contracts which have as the deliverable instrument a T-bill with a 13-week maturity.
2. U.S. Treasury Note and Bond Futures. Futures contracts which have as the deliverable instrument a U.S. Treasury Bond (with a maturity or call date of at least 15 years in the future) or a U.S. Treasury Note (with a maturity of either 4 1/4 to 5 1/4 years or 6 1/4 to 10 years).
3. Eurodollar Time Deposit Futures. Futures contracts which have as the deliverable instrument non-negotiable, fixed rate U.S. dollar deposits in banks that are not subject to U.S. banking regulations.^[1]

The Corporation intends to enter into the futures contracts to hedge its investment activity against market risk. For example, if the Corporation holds U.S. Treasury Notes and it believes that such Notes are about to go down in price due to some forthcoming market information, it might enter into a futures contract obligating it to make delivery of the Notes at a future date at a price reflecting the current, more beneficial market conditions.

II. DISCUSSION

Under G.L. c. 63, § 38B, Massachusetts extends favorable tax treatment to any domestic or foreign corporation which is "engaged exclusively in buying, selling, dealing in, or holding securities in its own behalf and not as a broker." In applying this requirement to specific facts, the Department views whether the instruments in question constitute "securities" and whether the actions contemplated are to be taken for investment purposes. See Industrial Finance Corp. v. State Tax Commission, 367 Mass. 360, 366 (1975) ("We hold that to qualify under G.L. c. 63, § 38B the corporation engaged exclusively in buying, selling, dealing in, or holding securities on its own behalf must do so for investment"); State Tax Commission v. PoGM Co., 369 Mass. 611, 612-13 (1976) (interest in question not the type of security which the Legislature contemplated in § 38B).

A. Securities Placement

The interests being conveyed in the Placement Transaction are securities as that term is defined in c. 63, § 38B. However, there is a question as to whether the transaction is referenced in the "buying, selling, dealing in, or holding" language of that provision. The only one of these four categories which might possibly include the Placement Transaction is the term "dealing in."

The term "dealing in" as used in c. 63, § 38B has not been previously defined. However, in analyzing c. 63, § 38B the Massachusetts Supreme Judicial Court ("SJC") has stated that "every word of a legislative enactment is to be given force and effect." Chatham Corp. v. State Tax Commission, 362 Mass. 216, 219 (1972). Therefore, we conclude that the term "dealing in" means more than just "buying," "selling" or "holding."

Moreover, the SJC in Chatham stated that "words...are to be construed according to their natural and ordinary meaning." Id. In Chatham the SJC defined the word "exclusively" as used in c. 63, § 38B by reference to the definition of that term in Black's Law Dictionary. Id. Black's Law Dictionary defines the verb "deal" as follows:

To traffic; to transact business; to bargain or trade. Also, to act between two persons, to intervene, or have to do with.

Black's Law Dictionary (5th ed.).

This definition would apparently include a short-term loan of securities.

In determining whether the Placement Transaction is referenced by the term "dealing in" we also consider the SJC's holding in Industrial Finance, that each of the activities listed in c. 63, § 38B (buying, selling, dealing in, or holding) must be carried out for investment purposes. Industrial Finance, 367 Mass. at 366. We find that the Placement Transaction meets with this test.

For the reasons set forth above, we conclude that the Placement Transaction is permissible under c. 63, § 38B.

B. Entering, Holding Futures Contracts

A futures contract is not generally considered to be a security.^[2] This is because the term "security" itself does not comprehend such a contract. See Loss, Securities Regulation, 276 (1988); P&C Investment Club v. Becker, 520 F.Supp. 120, 121 (E.D. Pa. 1981). Moreover, a futures contract is not included in the definition of an "investment contract," which has been held to constitute a security by the U.S. Supreme Court. See P&C Investment Club, 520 F. Supp. at 121.^[3]

However, where a future references a security as the underlying commodity (a "securities future"), there is some authority for the proposition that the future itself constitutes a security. See, e.g., Paine, Webber, Jackson & Curtis, Inc. v. Conaway, 515 F.Supp. 202 (N.D. Ala. 1981); Fisher v. Dean Witter Reynolds, Inc., 526 F.Supp. 558 (E.D. Pa. 1981); compare P&C Investment Club; Conroy v. Andeck Resources, 137 Ill. App. 3d 375 (1985). Paine Webber and Fisher were distinguished by Conroy because they involved fact situations arising under Rule 10b-5, promulgated under § 10 of the Securities Exchange Act of 1934, 15 U.S.C.A. § 78(j)(b). Conroy notes an interest may be more readily found a security under Rule 10b-5, since that section applies to fraud "in connection with the purchase or sale of any security." Conroy, 137 Ill. App. at 382-383.^[4]

We think that the term "dealing in" contained in c. 63, § 38B permits an analysis comparable to that which has been used under Rule 10b-5. That is, whether or not securities futures themselves constitute securities, we think that entering into and holding these interests constitutes "dealing in" underlying securities.^[5]

III. CONCLUSION

For the reasons set forth above, we conclude that both the Placement Transaction, and the Corporation's proposed activity with respect to securities futures, are permissible activities under c. 63, § 38B.

Very truly yours,

/s/Mitchell Adams

Mitchell Adams
Commissioner of Revenue

MA:HMP:mtf

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[1] This third kind of futures contract locks in a rate for borrowing or lending when the contract expires. The rate is based on a three-month, \$1 million Eurodollar time deposit; however, it is a cash settlement contract, so actual delivery of the time deposit does not take place. Although the underlying Eurodollar time deposits are non-negotiable, the Eurodollar futures contracts can be and frequently are actively traded.

[2] Trading in futures contracts, whether the underlying property is an agricultural commodity or financial instrument, is governed by the provisions of the Commodity Futures Trading Commission Act, 7 U.S.C.A. § 1 et seq. This Act defines the term "commodity" as "all services, rights and interests in which contracts for future delivery are presently or in the future dealt in...."

[3] "The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others...There is no evidence that a commodity contract is commonly given the character of a security in commerce. The purchaser of such a contract is in no way participating in a 'common enterprise' looking for his profits to come 'solely from the efforts of others.' A commodity future contract is just what the name implies: an undertaking to deliver or take delivery of a specified amount of the commodity at a specified time and place for a specified price...[The investor] is no way investing his money in a common enterprise, nor is he led to expect profits solely from the efforts of any third party. The 'enterprise' is an individual one. The expectation of profit arises solely from the speculative hope that the market price of the underlying commodity will vary in his favor, permitting purchase or sale at a profit." Id.

[4] The court stated "[w]here the commodity underlying a futures contract is a security, any allegedly fraudulent conduct in connection with the purchase or sale of that futures contract will necessarily be 'in connection' with a security". Conroy, 137 Ill. App. at 383.

[5] Eurodollar time deposits in banks not subject to U.S. banking regulations are securities. See Sanderson v. Roettenmund, 682 F.Supp. 205, 206 (S.D.N.Y. 1988). Consequently, the futures in question which reference these instruments as the underlying interest are securities futures.